

KERR-MCGEE CORP.

IBLA 90-484 Decided February 25, 1993

Appeal from a decision of the Director, Minerals Management Service, reconsidering on remand Minerals Management Service decisions requiring additional royalties on wet gas produced from oil and gas lease M-18951 (ND) (MMS-83-0033-O&G and MMS-87-0334-O&G), and assessing late payment charges on some of those royalties (MMS-88-0011-O&G).

Affirmed.

1. Oil and Gas Leases: Production: Wet Gas--Oil and Gas Leases: Royalties

Where applicable statutes and regulations require that the Minerals Management Service value wet gas production from a Federal lease on the greater of the gross proceeds accruing to the lessee from the sale thereof or the aggregate value determined by the Secretary of all the commodities, including residue gas, a valuation determination that royalty shall be paid on the value of one-third of all liquids extracted from the gas and 100 percent of the residue gas is properly upheld by the Director, Minerals Management Service.

APPEARANCES: Johnny J. Akins, Esq., Kerr-McGee Corp., Oklahoma City, Oklahoma, for appellant Kerr-McGee Corp.; Peter J. Schaumberg, Esq., Geoffrey Heath, Esq., Howard W. Chalker, Esq., Office of the Solicitor, U.S. Department of the Interior, Washington, D.C., for the Minerals Management Service.

OPINION BY DEPUTY CHIEF ADMINISTRATIVE JUDGE HARRIS

In Kerr-McGee Corp., 106 IBLA 72 (1988), after thoroughly discussing the history of the statutes, regulations, and Departmental policies governing the valuation of wet gas production from Federal lands, this Board set aside three decisions of the Director, Minerals Management Service (MMS). In those decisions, the Director had separately affirmed two MMS decisions requiring additional royalty for wet gas produced from Kerr-McGee's Federal Well No. 1-22, which is located on Kerr-McGee's Federal lease No. M-18951 (ND), in McKenzie County, North Dakota (MMS-83-0033-O&G, MMS-87-0334-O&G), and one decision assessing late payment charges for part of that additional royalty (MMS-88-0011-O&G). The Board remanded the matter to the Director to allow him to reconsider whether the valuation methods used were consistent with the gas valuation regulations, including the Secretarial interpretations thereof, Notice to Lessees and Operators No. 5 [NTL-5], and the Notice

to Lessees Numbered 5 Gas Royalty Act, P.L. 100-234, 101 Stat. 1719 (1988) (NTL-5 Act). 106 IBLA at 82. 1/

Pursuant to the Board's remand, MMS prepared a Supplemental Field Report (Supplemental Report), dated October 19, 1989. Therein, MMS stated:

The Royalty Valuation and Standards Division (RVSD) has consistently held that sales under a percentage of proceeds contract are wellhead sales, but since value is determined by a percentage of the value received at the tailgate of the plant, royalty must be computed on the higher of the value actually received by the producer or the value computed in accordance with the controlling regulations at 30 CFR Sections 206.105 and 206.106. These regulations establish a minimum value for gas sold under a percentage of proceeds contract equal to one-third of the value of the products extracted and sold plus 100 percent of the value of the residue gas.

* * * * *

Royalties were then calculated on the full value of the residue gas and one-third of the value of the NGL's [natural gas liquids] and sulfur. This was consistent with NTL-5, with the NTL-5 Act, with the regulations (30 CFR 206.106 (1988)), and with longstanding departmental practice.

Conclusion

The methods used by KM to value the residue gas, NGL's, and sulfur extracted from the wet gas stream under a "percent-of-proceeds" contract is not an acceptable method given the circumstances involved. One-hundred percent of the residue gas plus one-third of the value of the NGL's and sulfur was determined to comprise the total value of the gas at the wellhead. The authority for using the net realization method is found at 30 CFR 206.103, 30 CFR 206.105 and 30 CFR 206.106. Therefore, we recommend that KM's appeals be denied and MMS's position be affirmed.

(Supplemental Report at 3, 5).

1/ The history of this matter is set forth in detail in Kerr-McGee Corp., 106 IBLA at 73-74, and will not be repeated in this decision other than to note that for the period of time in question, Sept. 1981 through Dec. 1984, Kerr-McGee sold its production to Koch Hydrocarbon Company, at or near the wellhead, pursuant to a "Casinghead Gas Processing Agreement," dated Apr. 15, 1981. That agreement provided that the price paid to Kerr-McGee would be an amount equal to 70 percent of the net sales proceeds received by the processor for the liquefiable hydrocarbons, residue gas, and sulfur saved and sold, which is attributable to the producer's wellhead gas, less the fees attributable thereto. Kerr-McGee paid its royalties based upon this percentage of proceeds contract.

Kerr-McGee objected to the report in a written response dated November 21, 1989.

On June 7, 1990, the Director issued his decision on remand adopting the rationale from the Supplemental Report and reaffirming MMS' royalty valuation process and confirming its valuation methods to be in compliance with the regulations, NTL-5, and the NTL-5 Act. Therein, he provided the following explanation:

The earlier decisions rendered by the MMS Director and his delegate concluded that the royalty on the residue gas production be determined by valuing the gas at the NGPA section 102 ceiling price. This was the price received by the processor when the gas was sold. The liquids were valued in accordance with 30 CFR 206.106 (1983) at the tailgate of the processing plant. The Appellant was required to pay royalty on 100 percent of the residue gas and was given a processing allowance not to exceed two-third's of the value of the liquids extracted. The Appellant asserts that the royalty valuation should be determined by the proceeds received by the Appellant from the processor, i.e., 70 percent of the value of the residue gas and 70 percent of the value of the liquids and sulphur.

Effective June 1, 1977, the Department of the Interior established the method of calculating royalties due on natural gas production from onshore Federal and Indian oil and gas leases by issuance of Notice to Lessees and Operators No. 5 (NTL-5), 42 F.R. 22,610 (May 4, 1977). Under certain provisions of NTL-5 the base value, for royalty purposes, was the higher of the price received under the gas sales contract or the highest applicable ceiling rate then established by the Federal Power Commission. With the passage of the NGPA, the ceiling rate was subsequently interpreted to be the maximum lawful price established under the NGPA.

* * * * *

Between 1982 and 1986, gas prices in many areas declined below the maximum lawful prices established under NGPA because of gas oversupply and changing market conditions. Effective August 1, 1986, the Department modified those sections of NTL-5 referencing the NGPA maximum lawful price. The modification permitted natural gas production on and after August 1, 1986, to be valued using the full range of authority under the existing royalty valuation regulations at 30 CFR Part 206 rather than under the more restrictive provisions of NTL-5.

In January 1987, the Department proposed to modify NTL-5 retroactively for the period January 1, 1982, to July 31, 1986. See 52 F.R. 1,671 (January 15, 1987). The Notice to Lessees Numbered 5 Gas Royalty Act of 1987 (NTL-5 Act), Public Law 100-234

was signed by the President of the United States on January 6, 1988. The NTL-5 Act applies to natural gas production from onshore Federal and Indian oil and gas leases during the period from January 1, 1982, through July 31, 1986, which was required

to be valued under sections I.A.2, II.A.2, or VI of NTL-5 and provides that the value of gas for royalty purposes was to be determined in accordance with the regulations at 30 CFR Part 206.

The IBLA recognized that in Kerr-McGee the period of time involved included months preceding, and months following, the effective date of the NTL-5 Act, and the remand from IBLA requested that MMS verify that its computations were in conformity with the NTL-5 Act, as appropriate.

Pursuant to the remand from IBLA, MMS reviewed its previous calculations and concluded that the calculations were proper in light of the IBLA analysis of the applicable rules.

(Director's Decision at 2-5). Kerr-McGee filed this appeal.

In its statement of reasons (SOR), Kerr-McGee contends that the Director's decision on remand is arbitrary and capricious because, first, it ignores the inherent inconsistency between the net realization method and the market inquiry requirements of the NTL-5 Act and, second, it fails to provide adequate reasoning or support for the valuation method employed. Appellant argues that Congress intended that MMS should determine the value of production "based upon a review of market conditions applicable to the gas at the time and place produced" (SOR at 8). Kerr-McGee asserts that MMS, without complying with the "good reason to the contrary requirement" of the Act, elected to value production by using the net realization method of its wet gas rule instead of relying upon Kerr-McGee's evidence of the gross proceeds from its sales in a free and open market. Appellant argues that the MMS net realization method values production without adequate consideration being given to the market place in direct contradiction with the NTL-5 Act. Kerr-McGee contends that because MMS on remand from the Board did not provide adequate justification for rejecting evidence of market value as conclusive of production value, the Board should find that MMS royalty calculations based on the net realization method overvalued production and therefore order MMS to refund the resulting overpayments.

In its answer, MMS argues that the NTL-5 Act directs MMS to value gas pursuant to the regulations and that the Director precisely followed the regulations found in 30 CFR 206.103, 206.105, and 206.106. MMS contends that it compared Kerr-McGee's gross proceeds with the aggregate value of all commodities produced, less a processing allowance, and, in accordance with the regulations, selected the higher of the two as the value of production for royalty calculations. MMS asserts that its royalty valuation in this instance must be affirmed as being in accordance with the NTL-5 Act and Departmental regulations.

[1] Kerr-McGee's primary contention on appeal is that MMS does not properly interpret the NTL-5 Act. Kerr-McGee asserts that the NTL-5 Act "was enacted, in a narrow sense, to specifically address the 'inequities' caused by MMS use of NTL-5 to value production for royalty purposes. Its use of NTL-5 had not allowed for changed market conditions and, as a result, established a 'minimum value' that exceeded the market value of the gas produced (SOR at 6-7)." Appellant specifically refers to section 1(b)(8) of

the Act as a clear statement that Congress recognized this problem. That section provides:

The failure to adjust the method of calculating royalty payments resulting from changes in the gas market created various problems in valuation, produced inequitable situations for many lessees and payors whose gas market price was well below the Natural Gas Policy Act ceiling prices, and created uncertainty associated with the collection of royalty revenue. Uniform application of Natural Gas Policy Act ceiling prices was inequitable given market conditions during this period. For these reasons, it is necessary and appropriate for Congress to provide for certain adjustments through legislation.

101 Stat. 1720 (1988).

Kerr-McGee argues that Congress definitely intended that MMS determine the value of production based upon a review of market conditions applicable to the gas at the time produced (SOR at 8). Kerr-McGee quotes section 3(b) of the Act as further indicia of its position:

(b) ROYALTY CALCULATION FOR CERTAIN FEDERAL ONSHORE AND INDIAN OIL AND GAS LEASES.--If the gas referred to in subsection (a) of this section was produced from a Federal onshore or Indian lease, the value of production for the purpose of computing royalty, shall be the reasonable value of the product as determined consistent with the lease terms and the regulations codified at part 206 of title 30, Code of Federal Regulations in effect at the time of production. In establishing the reasonable value, due consideration shall be given to the highest price paid for a part or for a majority of production of like quality in the same field, to the price received by the lessee, to posted prices, and to other relevant matters. Under no circumstances shall the value of production of any of said substances for the purposes of computing royalty be deemed to be less than the gross proceeds accruing to the lessee from the sale thereof or less than the value computed on such reasonable unit value as shall have been determined by the Secretary. In the absence of good reason to the contrary, value computed on the basis of the highest price per thousand cubic feet or gallon paid or offered at the time of production in a fair and open market for the major portion of like-quality gas, or other products produced and sold from the field or areas where the leased lands are situated will be considered to be a reasonable value.

Kerr-McGee asserts that "[c]onsistent with the overall intent of the Act," section 3(b) requires that MMS must accept the highest price paid or offered as the reasonable value "[i]n the absence of good reason to the contrary" (SOR at 10). Kerr-McGee contends that MMS has not provided adequate reasoning for doubting the weight or relevancy of its evidence of market value.

The Board, however, noted in Kerr-McGee, 106 IBLA at 81, that "[t]he first sentence [of section 3(b)] states that gas valuation shall be the reasonable value of the product as determined by the regulations in 30 CFR Part 206. The next two sentences are essentially a quote of 30 CFR 206.103." The Board then noted the valuation methods applicable for the time periods in question and stated, "Therefore, it is clear that MMS was not bound, as appellant claims, to accept the contract price as the reasonable value of the gas production." 106 IBLA at 82.

Because MMS was not bound to accept Kerr-McGee's contract price as the reasonable value of production, the question is whether MMS properly applied the net realization method of valuation as set forth in the regulations at 30 CFR 206.105 and 206.106 to value production. 2/

The NTL-5 Act directed that royalty payments from Federal leases for the defined period be reviewed on a case-by-case basis. Further, section 3(b) of the NTL-5 Act clearly instructed that "the value of production * * * shall be determined consistent with the lease terms and the regulations codified at [30 CFR Part 206]" and that "the value of production [shall not] be less than the gross proceeds accruing to the lessee from the sale thereof or less than the value computed on such reasonable unit value as shall have been determined by the Secretary." The Secretary's valuation methods for the audit periods in question were set forth in the regulations at 30 CFR 206.105 and 206.106, which established a minimum value for gas equal to one-third of the value of the products extracted (reflecting a manufacturing allowance) plus 100 percent of the value of the residue gas. Thus, we find that the relevant statutes and regulations call for a comparison of values in the instant situation and require the selection of the one resulting in the greater value.

2/ Effective Mar. 1, 1988, the Department completely revised the regulations in 30 CFR relating to gas valuation for royalty purposes. 53 FR

1230 (Jan. 15, 1988). Our decision here is therefore concerned with the controlling regulations in effect during the royalty collection periods

at issue here, 1981 through 1984. 30 CFR 206.105 (1984), entitled "Royalty on gas," provides at subsection (c):

"(c) For the purpose of computing royalty, the value of wet gas shall be either the gross proceeds accruing to the lessee from the sale thereof or the aggregate value determined by the Secretary of all commodities, including residue gas, obtained therefrom, whichever is greater."

30 CFR 206.106 (1984), entitled "Royalty on casing-head or natural gasoline, butane, propane, or other liquid hydrocarbon substances extracted from gas," states in pertinent part:

"A royalty as provided in the lease shall be paid on the value of one-third (or the lessee's portion if greater than one-third) of all casinghead or natural gasoline, butane, propane, or other liquid hydrocarbon substances extracted from the gas produced from the leasehold. The value of the remainder is an allowance for the cost of manufacture, and no royalty is required."

The 1982 codification of these regulations was found at 30 CFR 221.50 and 221.51, respectively, while 30 CFR 206.103 (1984), was located at 30 CFR 221.47 (1982).

Kerr-McGee contends that the Department has not consistently applied the wet gas regulations. Citing Jicarilla Apache Tribe v. Supron Energy Corp., 728 F.2d 1555, 1558 (10th Cir. 1984), it claims that at least from 1950 through 1979, it was the practice of the Department only to apply those regulations where the producer of casinghead gas was also an owner in the plant processing such gas. Kerr-McGee acknowledges that the court reversed that decision on en banc rehearing in Jicarilla Apache Tribe v. Supron Energy Corp., 782 F.2d 855 (10th Cir.), en banc opinion supplemented, 793 F.2d 1171 (10th Cir.), cert. denied, 107 S. Ct. 471 (1986). Kerr-McGee characterizes the reversal as being "for other reasons" (SOR at 14). However, the court stated in that opinion that the majority of the court was adopting the prior dissenting opinion of Judge Seymour reported at 728 F.2d 1555, 1563 (10th Cir. 1984), in which Judge Seymour concluded in reference to 30 CFR 221.50(c) (1982)(later 30 CFR 206.105(c) (1984)):

The second clause of subsection 221.50(c) authorizes Interior to use the aggregate value of the substances contained in wet gas, ensuring that the lessor will receive the true value of the gas and other hydrocarbons produced from its lands, regardless of the lessee's choice of marketing tactics. Subsection (c) does not by its terms require that the lessee itself extract liquids before the Secretary may utilize aggregate value computing; to the contrary, it appears to apply in all situations. [Emphasis in original.]

Accordingly, regardless of the consistency of the application of the rule, the court recognized that the regulation itself contained no limitation on its application.

The shortcoming of Kerr-McGee's wet gas valuation is two-fold. First, Kerr-McGee's method values only a portion of the residue gas. Second, Kerr-McGee's computations are based on processing costs which appear from the worksheets submitted to MMS to exceed the allowance provided in the regulations. As argued by Kerr-McGee, the valuation standards discussed place principal reliance on the marketplace, with the assumption that a lessee will seek to obtain the best possible price for its production. The regulations, as set forth, however, allow for acceptance of the contract price received by the lessee for purposes of valuation for royalty, but also require that such value be scrutinized and supplanted if it is not sufficient by Departmental standards. Thus, where the proceeds received do not reflect the reasonable value of production because the manufacturing or processing costs exceed the accepted maximum allowances, MMS is not bound to accept the contract price. This situation was identified by MMS in its review of the instant case.

Upon reviewing the evidence and arguments in this case, we must agree with the Director, MMS. During the time periods in question, September 1981 through December 1982, and January 1983 through December 1984, MMS computed royalties on 100 percent of the value of the residue gas and one-third of the value of the hydrocarbons in accordance with NTL-5, the NTL-5 Act, and

the regulations, as discussed above. 3/ In both situations, MMS followed applicable regulations by comparing Kerr-McGee's gross proceeds to the aggregate value of all commodities less a manufacturing allowance. MMS then selected the greater of the two values in accordance with 30 CFR 206.105(c). 4/ Therefore, we must affirm the appealed decision affirming MMS' determinations in MMS-83-0033-O&G and MMS-87-0334-O&G.

As Kerr-McGee does not challenge the interest assessed on the late payments, the Director's decision, as it relates to the matter appealed in MMS-88-0011-O&G, must also be affirmed.

Accordingly, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 CFR 4.1, the decision of the Director, MMS, is affirmed.

Bruce R. Harris
Deputy Chief Administrative Judge

I concur:

John H. Kelly
Administrative Judge

3/ In the Supplemental Report at 4-5, MMS stated:

"The royalty calculations performed by the State use a unit price for residue gas which excludes the deduction for processing, and is taken directly from Koch's purchase statements. It is apparent that this price is paid for the entire audit period pursuant to the terms of the Agreement and is the same as the monthly NGPA Section 102 price as published by the Federal Energy Regulatory Commission. Having a value for residue gas which is the result of an arm's length transaction, KM needed only to eliminate the processing deductions made by Koch in order to bring monthly royalties in accordance with the controlling regulations at 30 CFR Part 206."

4/ In Kerr-McGee, we instructed the Director to review a decision of the Director, Geological Survey, approved by the Acting Secretary on Feb. 28, 1947, to determine if it had any relevance to valuation in this case. That decision stated that value for royalty purposes should be computed on "one of the following bases, whichever results in the greater royalty, whenever it appears that the cost of manufacture is reflected in both gas and liquids retained by the processor" (Decision at 4). Those bases were gross market value of all such products less extraction cost or the value of one-third of the gasoline, butane, propane, and other liquid substances extracted from the gas and all of the residue dry gas available for sale. In its Supplemental Report, MMS concluded that the Director complied with that decision by valuing the gas in question based on one-third of the value of the liquids and 100 percent of the dry gas. We agree.